# U.S. Public Interest Research Group
National Association of State PIRGs



28 March 2006

Robert Feldman
Executive Secretary
Attention: Comments/Legal ESS, Room 3060
FDIC
550 17th St NW
Washington, DC 20429

RE: Summary of Testimony of U.S. PIRG In Opposition to Application for Deposit Insurance For Proposed Wal-Mart Bank

**Summary Only**

On behalf of the state Public Interest Research Groups and their individual members in 50 states, U.S. PIRG strongly urges the FDIC to reject the application of Wal-Mart Stores, Inc. to receive FDIC insurance for an industrial bank chartered in Utah. Allowing the largest retail firm in the world to purchase an industrial loan company (ILC) would represent a dangerous and unprecedented blend of banking and commerce.

Why should a consumer advocacy group, one that that has published numerous reports extolling the need for greater competition in the banking marketplace, oppose entry by a powerful potential competitor like Wal-Mart? Simply, a Wal-Mart Bank will not improve competition. It will, however, pose risks to the taxpayer-guaranteed deposit insurance fund while also posing broader credit misallocation risks to the greater economy.

Not only do we urge FDIC rejection of the Wal-Mart application, we urge that the Congress shut down the risky, under-regulated parallel banking system that Wal-Mart and other powerful financial and commercial interests seek to take advantage of to avoid prudential regulation.

Sincerely,

Edmund Mierzwinski

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Consumer Program Director

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## Testimony

U.S. PIRG serves as the federal lobbying office for the National Office of State Public Interest Research Groups. PIRGs are non-profit, non-partisan public interest advocacy groups with over 500,000 members. We have members in every state. We have long had an interest in ensuring competition in the banking and financial system and also in protecting the safety and soundness of that taxpayer-guaranteed system.

On behalf of the state Public Interest Research Groups and those individual members, U.S. PIRG strongly urges the FDIC to reject the application of Wal-Mart Stores, Inc. to receive FDIC insurance for an industrial bank chartered in Utah. Allowing the largest retail firm in the world to purchase an industrial loan company (ILC) would represent a dangerous and unprecedented mix of banking and commerce.

Rending such a hole in the wall between commerce and banking as Wal-Mart proposes, through the backdoor of an under-regulated Utah ILC, poses grave risks to the taxpayer-insured financial system and, more broadly, to the economy.

It would allow Wal-Mart to offer many of the same services and loans as commercial banks without the same rigorous regulatory oversight. (Although Wal-Mart has stated that it does not intend to offer banking services or make loans, it could change its mind at any time once it is allowed to set up an ILC.) This has enormous negative implications for the safety and soundness of a Wal-Mart-owned bank and for taxpayers who backstop the deposit insurance system.

Wal-Mart's application violates long-standing principles of banking law that commerce and banking should not mix. Recent corporate scandals show the serious risks involved in allowing any commercial entity to own a bank without significant regulatory scrutiny at the holding company level.

## ILCs Are Exempt From The Bank Holding Company Act

ILCs are exempt from the Bank Holding Company Act (BHCA) which allows the Federal Reserve to conduct examinations of the safety and soundness not just of banks, but of the parent or holding company of these banks.

The BHCA also grants the Federal Reserve the power to place capital requirements and impose sanctions on these holding companies. The FDIC does not have these powers.

Oversight of the holding company is the key to protecting the safety and soundness of the banking system. It is immaterial whether the owner of the bank is a financial or a commercial entity. Holding company regulation is essential to ensuring that financial weaknesses, conflicts of interest, malfeasance or incompetent leadership at the parent company will not endanger the taxpayer-insured deposits at the bank.

Years of experience and bank failures have shown this to be true. For example, recent accounting scandals at Sunbeam, Enron, Worldcom, Tyco, Adelphia and many others involved deliberate deception about the financial health of the companies involved. If these companies had owned banks, not only would employees, investors and the economy have suffered, but taxpayers as well.

Moreover, allowing a Wal-Mart-owned industrial bank to enter the FDIC system would further widen the ILC loophole to the BHCA, which should instead be closed. It is time to shut down this parallel banking system, not allow its further expansion. We strongly urge the FDIC to deny Wal-Mart's application.

**ILCs Have Transmogrified Into Something They Were Never Intended To Be**

ILCs were never intended to be large, nationwide banks that offered services indistinguishable from commercial banks. In 1987, Congress granted an exception to the BHCA for ILCs because there were few of them, they were only sporadically chartered in a small number of states, they held very few assets and were limited in the lending and services they offered. In fact, this exception specifically applied only to ILCs chartered in five states (Utah, California, Colorado, Nevada and Minnesota) that have either assets of less than $100 million or do not offer checking services. Since that time, however, everything about ILCs has grown: the number that exist, the amount of assets and federally insured deposits in them and the services and lending products that they can offer.

According to the Federal Reserve, the majority of ILCs had less than $50 million in assets in 1987, with assets at the largest ILC at less than $400 million. As of 2003, one ILC owned by Merrill Lynch had more than $60 billion in assets (and more than $50 billion in federally insured deposits) while eight other large ILCs had at least $1 billion in assets and a collective total of more than $13 billion in insured deposits. Moreover, the five states cited in the law are aggressively chartering new ILCs, allowing them to call themselves "banks" and giving them almost all of the powers of their state chartered commercial banks. These states, especially Utah, are also promoting their oversight as a less rigorous alternative to bank holding company oversight at the Federal Reserve.

According to the General Accounting Office (GAO), ILC assets grew by over 3,500 percent between 1987 and 2004, from $3.8 billion to over $140 billion. In 2004, six ILCs were among the 180 largest financial institutions in the country with $3 billion in assets. According to the Federal Reserve, the majority of ILCs had less than $50 million in assets in 1987, with assets at the largest ILC at less than $400 million. As of 2003, one ILC owned by Merrill Lynch had more than $60 billion in assets (and more than $50 billion in federally insured deposits).

**Utah Has Become A Haven For Companies Seeking To Ignore Prudential BHCA Regulation**

Moreover, some of the states that are allowed to charter ILCs are aggressively chartering new institutions, allowing them to call themselves "banks" and giving them almost all of the powers of their state chartered commercial banks. These states, especially Utah, are also promoting their oversight as a less rigorous alternative to those of the pesky regulators at the Federal Reserve.

For example, the web site of the Utah Department of Financial Institutions has trumpeted its "positive regulatory environment" and declares that "ILCs offer a versatile depository charter for companies that are not permitted to, or that choose not to, become subject to the limitations of the Bank Holding Company Act."

**Other Firms, Besides Wal-Mart, Deserve Closer FDIC Scrutiny**

We note also that large financial firms should similarly not be permitted to establish a parallel banking system that is not subject to the rigorous oversight required for real banks. This represents an enormous and unacceptable risk to taxpayers. Securities firms that own ILCs have taken the lead in promoting the ILC expansions. They have not been shy about stating that they want to expand ILC powers because they do not want to deal with the regulatory oversight they would face from the Federal Reserve if they purchased a bank, as allowed under the Gramm-Leach-Bliley Act. Instead, they prefer to set up a "shadow" banking system through ILCs. They want to be able to offer the same services and loans as commercial banks without the same regulatory oversight. We encourage the FDIC to look negatively on their applications also.

According to the Federal Reserve, deposits in ILC accounts are not as secure as those in real banks. As mentioned above, ILCs are exempt from the BHCA, which allows the Federal Reserve to conduct examinations of the safety and soundness not just of banks, but of the parent or holding company of these banks. The BHCA also grants the Federal Reserve the power to place capital requirements and impose sanctions on these holding companies. The Federal Deposit Insurance Corporation (FDIC), which regulates ILCs, does not have these powers. In its recent report, the GAO concurred with this assessment:

Although FDIC has supervisory authority over an insured ILC, it has less extensive authority to supervise ILC holding companies than the consolidated supervisors of bank and thrift holding companies. Therefore, from a regulatory standpoint, these ILCs may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company…. Further, FDIC's authority has not been tested by a large ILC parent during times of economic stress.

### How Big and Powerful Is Wal-Mart's Effect On The Economy and What Threats Does Credit Misallocation Pose?

One expert, Stacy Mitchell of the Institute for Local Self-Reliance, has stated the following:

> It is the world's top buyer of just about everything from groceries and clothing to books and toys, and as the world's top buyer, Wal-Mart's power extends from its 5,000 superstores all the way back to the farmer's fields and to the factory floor and to the publishing houses—to everywhere that goods are made, all over this planet. Those are the tentacles that Wal-Mart sends out into the world. No other company on earth exerts as much control over how and where goods are produced.[1]

If Wal-Mart were to unleash that power and control onto additional financial services – such as credit and loans -- by changing the business plan it has presented to you, numerous problems could occur in addition to those already described above related to safety and soundness. As prudential banking expert Jonathan Brown has pointed out, the grave threat of potential credit misallocation posed by mixing banking and commerce is a major reason we have a wall between banking and commerce.

> Given that the banking regulators are already overburdened with the task of controlling bank soundness, it is quite unrealistic to expect them to monitor and detect more subtle bias in the vast array of loans that banks would make to commercial affiliates, their suppliers and their customers if the mixing of banking and commerce were permitted. The mixing of banking and commerce threatens economic injuries that have a far broader reach and potential for economic damage than the more narrow economic harms posed by integration within the financial service sector, such as conflicts of interest in the distribution of securities, use of insider information, and the tying of insurance products to credit. In large measure, this difference in potential harm stems from the fact that bank/commercial firm affiliations link financial intermediaries with ultimate end-users of credit, while financial integration merely combines different types of financial intermediaries. In an economy where depository institutions are broadly linked to end-users of credit, the potential for distortions in the flow of credit is enormous.[2]

### A Series of Federal Reserve Leaders Has Opposed Increased ILC Powers

In perhaps his last statement to the Congress, in January former Chairman Alan Greenspan sent a detailed letter to letter to Representative Jim Leach (R-IA), who had been chairman, House Banking Committee, in 1999 when the Congress maintained the wall between banking and commerce.

> The character, powers and ownership of ILCs have changed materially since Congress first enacted the ILC exemption. These changes are undermining the prudential

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[1] Jul. 26, 2005, Will Wal-Mart Eat Britain? Talk delivered in London on May 26, 2005, sponsored by the New Economics Foundation. Available at http://www.newrules.org/retail/nefspeech.pdf
[2] See "The Separation of Banking and Commerce," Jonathan Brown, available at http://www.public-gis.org/reports/sbc.html

> framework that Congress has carefully crafted and developed for the corporate owners of other full-service banks. Importantly, these changes also threaten to remove Congress' ability to determine the direction of our nation's financial system with regard to the mixing of banking and commerce and the appropriate framework of prudential supervision.[3]

Similar views had been stated by Federal Reserve Governor Lawrence Meyer in 1998:

> [W]e are not sure enough of the implications of combining banking and commerce--potential conflicts of interest, concentration of power, and safety net and stability concerns--to move forward in this area.[4]

In 1991, Gerald Corrigan, president of the Federal Reserve Bank of New York, told Congress that the potential for credit misallocation inherent in such combinations constitutes a threat to "the impartiality of the credit decision-making process" that goes "right to the heart of one of the most important functions of banking in a market economy."[5]

## Conclusion

Thank you for the opportunity to present our views today. Not only do the state PIRGs urge FDIC rejection of the Wal-Mart application, we urge that the Congress shut down the risky, under-regulated parallel banking system that Wal-Mart and other powerful financial and commercial interests seek to take advantage of to avoid prudential regulation.

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[3] Letter from then-Federal Reserve Board Chairman Alan Greenspan, 20 January 2006 letter to Representative Jim Leach (R-IA), former chairman, House Banking Committee. New Chairman Ben Bernank has not altered these views of the Fed.

[4] Remarks by Governor Laurence H. Meyer, At the Bank Administration Institute, Finance and Accounting Management Conference, Washington, D.C. June 9, 1998
http://www.federalreserve.gov/BoardDocs/speeches/1998/19980609.htm

[5] Quoted in Risk, Regulation, & Responsibility, Reforming the Banks, by Jonathan Brown, in Multinational Monitor, June 1991, Vol. 12, No. 6.